

Machinery and equipment used primarily in the manufacturing or assembling of tangible personal property for wholesale or retail sale or lease is exempt from the Retailers' Occupation Tax. See 86 Ill. Adm. Code 130.330. (This is a GIL.)

April 5, 2001

Dear Xxxxx

This letter is in response to your letter delivered to the Department by e-mail on February 7, 2001. The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120 subsections (b) and (c), which can be found at <http://www.revenue.state.il.us/legalinformation/regs/part1200>.

In your letter, you have stated and made inquiry as follows:

We are forwarding this email to your attention to request a response from the Illinois Department of Revenue regarding the application of certain sales and use tax exemptions under the following scenario:

Taxpayer develops and manufactures equipment for its end user customers. The taxpayer also develops software that is an integral part of the equipment manufactured and sold to its customers. The equipment is used by its customers in the food processing industry in many different arenas such as, but not limited to, sizing, cutting, weighing, portioning, separating, grading, labeling and data collection. The equipment consists of either fully integrated systems or segmented pieces of equipment and related software.

The taxpayer is unclear as to whether the sale of the equipment to its Illinois customers is exempt from Illinois sales and use tax. It is the taxpayer's understanding that the sale may qualify for an exemption under the Illinois statute.

Under the Illinois statute "the sale of machinery and equipment used primarily (over 50%) in the process of manufacturing or assembling, either in a new, expanded, or existing manufacturing facility, of tangible property for wholesale or retail or lease is exempt from the ROT and UT (35 ILCS 105/3-5, 105/3-50, 120/2-5 and 105/2-45; 86 ILL Adm. Code Secs. 130.120(q), 130.330(a) and 130.330(d)). The sale or transfer of machinery and equipment as described above is also excluded from the definition of "sale of service" and therefore not subject to the SOT or SUT (35 ILCS 110/2, 115/2; 86 ILL Adm. Code Secs. 140.125(o) and 140.201(e)(7)).

The statute defines the "manufacturing process" as the production of any article of tangible personal property, whether a finished product or one used in the manufacture

or assembly of another product, by procedures commonly regarded as manufacturing, processing, fabricating or refining that change substantially or significantly some existing material into a material with a different form, use, or name (35 ILCS 105/3-50, 120/2-45, 110/2,115/2; 86 Adm. Code Sec. 130.330(b)). Further, mining, quarrying, logging, oil or gas drilling, printing, agricultural or horticultural activities and the preparation of food and beverages are not considered to be manufacturing activities (86 ILL. Adm. Sec. 130.330(b)).

The "assembling process" is defined as the production of any article of tangible personal property by combining existing materials in a way that is commonly regarded as assembling in order to produce a material in a different form, use, or name (35 ILCS 105/3-50, 120/2-45,110/2,115/2; 86 ILL Adm. Sec. 130.330(b)).

"Machinery" is defined as major mechanical machines or major components of such machines that contribute to a manufacturing or assembling process. "Equipment" means any independent device or toll separate from the machinery but essential to an integrated manufacturing or assembling process, including computers used primarily in operating exempt machinery and equipment in a computer-assisted design, computer assisted manufacturing system (35 ILCS 105/3-50, 120/2-45,110/2,115/2; 86 ILL Adm. Sec. 130.330(c)).

One of the taxpayer's primary concerns is whether the manufacturing exemption extends to the machinery and equipment it develops and sells to its food processing customers. Additionally, if the machinery and equipment exemption does apply to taxpayer's sales of food processing machinery and equipment, does it also apply to the software developed by its company and sold as an integral part of the machinery and equipment?

The software is developed by the client and may be sold in a canned format. The software is integral to the operation of the machinery and equipment. On occasion, the software may be customized for a particular customer's use. In certain instances, the software may be licensed to the customer. It is the taxpayer's understanding that the software may be exempt if sold as an integral operating part of the machinery and equipment. It is also the taxpayer's understanding that licensed software may also be exempt if certain criteria are met:

1. Written agreement between the taxpayer and its customer;
 2. Customer duplication of the software is restricted;
 3. Licensing, sublicensing or transfer of the software to a third party is prohibited;
 4. If customer loses or damages the software, taxpayer will provide another copy at minimal or no charge; and,
 5. Copies must be destroyed or returned to the taxpayer at the end of the license period (86 ILL. Adm. Sec. 130.1935(a)(1)(A-E).
- (Criteria 4 are not required to be committed to the written license agreement, if the taxpayer's records reflect that such a policy exists. Criteria 5 are deemed to have been met for perpetual license agreements without such provision committed to the written license agreement.)

The taxpayer respectfully request that the Department respond via email and confirm whether the taxpayer's sales of machinery and equipment to its end user customers is exempt from sales and use tax under the Illinois statutes. Additionally, the taxpayer respectfully requests that the Department also address the sale and use tax treatment of the software.

If you have any questions or need clarification, please contact the undersigned.

DEPARTMENT RESPONSE:

Machinery and equipment that is used primarily (over 50% of the time) in the manufacturing or assembling of tangible personal property for wholesale or retail sale or lease is exempt from Retailers' Occupation Tax. See 86 Ill. Adm. Code 130.330. The manufacturing process is the production of any article of tangible personal property, whether such article is a finished product or an article for use in the process of manufacturing or assembling a different article of tangible personal property, by procedures commonly regarded as manufacturing, processing, fabricating, or refining which changes some existing material or materials into a material with a different form, use, or name. These changes must result from the process in question and be substantial and significant. See Section 130.330.

Your letter states that the equipment your client sells is used in the "food processing industry" in ways that include, but are not limited to, "sizing, cutting, weighing, portioning, separating, grading, labeling and data collection." Due to the limited information provided, we cannot confirm that the activities of your client's customers constitute manufacturing or that the manufacturing machinery and equipment exemption is applicable. Please note that the machinery or equipment must be used by the purchaser primarily (over 50% of the time) in manufacturing or assembly and that manufacturing and assembly does not include the preparation of food and beverages by restaurants, food service establishments, and other retailers. See Section 130.330(b)(7). The use of machinery and equipment for labeling or data collection do not generally qualify for the exemption unless they are used as part of an integrated manufacturing process. See subsections (d)(3)(C) and (d)(3)(D) of Section 130.330.

Generally, sales of "canned" computer software are taxable retail sales in Illinois. However, if the computer software consists of custom computer programs, then the sales of such software may not be taxable retail sales. See subsection (c) of the enclosed copy of 86 Ill. Adm. Code 130.1935. Sales of software are taxable regardless of the means of delivery. For instance, the transfer or sale of canned computer software downloaded electronically would be taxable. The definition of equipment for the manufacturing machinery and equipment exemption includes an independent device or tool separate from machinery but essential to an integrated manufacturing or assembly process: including computers used primarily in operating exempt machinery and equipment in a computer assisted design, computer assisted manufacturing (CAD/CAM) system. See subsection (c)(3) of Section 130.330. In addition, Section 2-25 of the Retailers' Occupation Tax Act provides that the term "computer software" for purposes of the Act does not include "software used to operate exempt machinery and equipment used in the process of manufacturing or assembling tangible personal property for wholesale or retail sale or lease." 35 ILCS 105/3-25; and 35 ILCS 120/2-25. If canned computer software is used to operate exempt machinery and equipment used in

the process of manufacturing or assembling tangible personal property for wholesale or retail sale or lease, then it may also not be subject to tax.

Custom computer programs or software are prepared to the special order of the customer. The selection of pre-written or canned programs assembled by vendors into software packages does not constitute custom software unless real and substantial changes are made to the programs or creation of program interfacing logic. See subsection (c)(3) of Section 130.1935.

If transactions for the licensing of computer software meet all of the criteria provided in subsection (a)(1) of Section 130.1935, neither the transfer of the software or the subsequent software updates will be subject to Retailers' Occupation Tax. A license of software is not a taxable retail sale if:

- A) It is evidenced by a written agreement signed by the licensor and the customer;
- B) It restricts the customer's duplication and use of the software;
- C) It prohibits the customer from licensing, sublicensing or transferring the software to a third party (except to a related party) without the permission and continued control of the licensor;
- D) The licensor has a policy of providing another copy at minimal or no charge if the customer loses or damages the software, or permitting the licensee to make and keep an archival copy, and such policy is either stated in the license agreement, supported by the licensor's books and records, or supported by a notarized statement made under penalties of perjury by the licensor; and
- E) The customer must destroy or return all copies of the software to the licensor at the end of the license period. This provision is deemed to be met, in the case of a perpetual license, without being set forth in the license agreement.

Charges for updates of canned software are fully taxable pursuant to Section 130.1935. If the updates qualify as custom software under subsection (c) of Section 130.1935, they may not be taxable. But, if maintenance agreements provide for updates of canned software, and the charges for those updates are not separately stated and taxed, then the whole agreement would be taxable as sales of canned software.

I hope this information is helpful. The Department of Revenue maintains a website, which can be accessed at www.revenue.state.il.us. If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of Section 1200.110(b) described above.

Very truly yours,

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Associate Counsel

TDC:msk
Enc.